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Hungary

Financial Sector Reform in a Socialist Economy

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and
Silvia B. Sagari

The first steps of the Hungarian financial reform are in the right direction, and given the short time elapsed they have been successful. But administrative and technical obstacles remain, and a deepening of supporting measures is required.

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This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in PRE to analyze sector reform in socialist economies in transition. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Zena Seguis, room N9-005, extension 37665 (26 pages, including figures).

Financial reforms in formerly centrally planned economies take a different form than in market economies because they imply not only liberalizing the system but also reshaping the structure and functioning of financial markets. And the reforms must be designed to facilitate the conduct of monetary policy under rapidly changing economic circumstances. To fulfill this role, financial reforms should (1) provide the authorities with monetary policy instruments that contribute to short-term stabilization and (2) provide the incentives for inducing a more efficient intermediation of savings through the financial markets.

In this context, Blejer and Sagari identify the main tasks and targets of financial reform and comment on the key developments of the Hungarian process.

Hungary has made substantial progress, they conclude, but macrofinancial indicators suggest that administrative and technical obstacles remain and that supporting measures must be deepened. Four steps in particular are needed:

- The ability of the monetary authority to conduct monetary policy must be enhanced.

- The operating and financial condition of financial intermediaries must be improved.

- Healthy competition among financial intermediaries must be encouraged.

- A prudential regulatory framework that does not discriminate against the development of a securities market must be established.

Hungary:
Financial Sector Reform in a Socialist Economy

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Hungary: Financial Sector Reform in A Socialist Economy

Mario I. Blejer and Silvia B. Sagari[1]

The economic reforms that are under way in many centrally planned economies (CPEs) are part of a general process of social and political restructuring. As such, they cannot be analyzed in isolation; their aims and achievements must be assessed in the broad context of wide systemic changes. Nevertheless, it is possible to focus on specific areas of the reforms and to examine (i) the objectives set for these areas, (ii) the design of specific policies within the framework of these objectives, and (iii) the achievements and the required conditions for the successful implementation of the policies.

I. The Framework

The central goal of economic reforms is to establish a system that responds to market forces and is therefore more efficient and dynamic. To this end, economic decision making should be decentralized, and economic agents should be allowed to freely dispose of their profits, as well as be accountable for the losses arising from their economic management decisions.

As economic units become more independent, behaving and reacting as they would in a competitive environment, the nature of macroeconomic management changes substantially: more emphasis has to be given to incentives and to indirect levers that manage and regulate the behavior of the increasingly autonomous economic agents and less attention should be placed on administrative controls. Under the strict central planning system prevailing before reform,

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[1] IMF and World Bank, respectively.

macroeconomic policy allocates--administratively--resources and regulates directly the rate of capital accumulation. This is largely achieved by maintaining family income levels within the constraints set by the envisaged supply of consumer goods. With the implementation of the reforms, market signals will guide economic agents. Macroeconomic policy will then need to adapt in order to influence indirectly individuals' behavior with the objective of achieving government targets, such as growth and investment levels, while avoiding imbalances and thus preserving stability. Given the central role that financial and monetary policies play in the macroeconomic context, the nature and characteristics of financial reforms--which set the stage for monetary management--should be carefully analyzed.

Financial reforms in CPEs take a different form than in market economies because they imply not only liberalizing the system but also reshaping the structure and functioning of financial markets. In addition, the reforms must be designed in a way that facilitates the conduct of monetary policy under rapidly changing economic circumstances. To fulfill this role, financial reforms should (i) provide the authorities with monetary policy instruments that contribute to the short-term stabilization process, and (ii) provide the incentives for inducing a more efficient intermediation of savings through the financial markets.

Prior to the reforms, under strict Soviet-type central planning, the banking sector was totally centralized and monetary policy was simply implemented through a dual-payment system: a credit plan and a cash plan. Credit was extended essentially to supply working (and in some cases investment) capital to the enterprise sector. The cash plan, on the other hand, covered the various components of the short-run demand for liquidity in the system, for instance, payments of wages. In fact, however, the Central Bank had little control over most of the factors affecting the amount of currency in the economy, which was decided by the planning authority.

At the inception of the reforms, the monetary and the financial systems of the CPEs needed to be substantially restructured. First, as mentioned, it is necessary to <u>provide instruments for indirect monetary control</u>. This could enable the authorities to manage macroeconomic aggregates more efficiently and depend less on intervention in micro-level decision-making (which would in turn go against the "spirit" of the reforms in terms of enterprise autonomy.) Instruments for this purpose were not available. Second, since more liquidity and financial resources will be left for free disposal by both the household and the enterprise sectors, <u>instruments that can channel surplus funds toward the financial markets</u> should be made available. Third, since credit planning is utilized to a lesser degree, it is important to develop <u>decentralized mechanisms so that credit will be allocated efficiently among enterprises</u>. In particular, as suppliers of funds to this sector, banks have an important role to play at the microeconomic level, allocating loans on the expectation that the enterprise will be profitable, and consequently raise the efficiency of investment. Fourth, since the intermediation role of the financial market will increase, an <u>institutional framework</u> is required that includes financial intermediaries that can supply all financial services required. Such a framework should allow and encourage competition in financial markets. Fifth, in this context, the <u>role of regulation</u> must be enhanced. As economic decisions become increasingly decentralized, the need becomes crucial for an adequate prudential regulatory and supervisory framework that, without unduly restricting the operations of financial intermediaries and capital markets, prevents excessive risk-taking.

Omissions in this area may lead to generalized financial chaos and crisis.[2] Sixth, since firms will be allowed and encouraged to finance their operations through different mixes of sources, securities and capital markets should offer a variety of debt and equity options.

Clearly, all these different aspects are interrelated. In this paper we look at the case of Hungary in which such interrelations as well as the success of the authorities in achieving the objectives of financial reform are considered. Section II briefly reviews the macroeconomic environment in Hungary while Section III covers various aspects of the nature of reforms carried out. Section IV provides an assessment of the process, and Section V some concluding remarks.

II. Overview of Macroeconomic Developments since 1968

At the time of the worldwide economic shocks of the 1970s', Hungary was pursuing expansionary growth policies. To postpone any reduction or adjustment of those policies, Hungary responded to the shocks by borrowing abroad. In 1981, an external financing crisis brought the strategy to an end. Hungary sought then the support of the IMF and the World Bank to help restore its access to international financial markets. During 1982-84, stabilization eclipsed reform. By 1984, macro-balances were restored, rescheduling had been avoided and, in fact, Hungary had regained its credit-worthiness in the view of the world financial community. The economy appeared to have stabilized successfully. But, the turnaround came mainly from cuts in investment; it was not accompanied by a comprehensive effort to address the structural sources of excess demand, low

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[2] And feed back quite strongly into any inflationary processes and fiscal deficits existing in the economy. For experiences in Latin America see, for example, Carlos Diaz-Alejandro, 'Good-Bye Financial Repression, Hello Financial Crash', Journal of Development Economics, September-October 1985.

productivity, and weak external competitiveness of industry.

Macroeconomic imbalances resurfaced in 1985-86. While the deterioration resulted in part from external factors, such as weakening terms of trade and successive droughts, the main reason was the premature relaxation of macroeconomic controls on aggregate demand (loose fiscal and monetary policy and inordinate wage increases). The major economic policy problem which continued, into the first half of 1987, was the persistence of fiscal imbalances stemming from the sizable budgetary subsidies and from other financial supports to inefficient firms. These supports, coupled with excessive credit availability, maintained the high level of domestic demand. By early 1987, the authorities instituted a series of measures to improve export incentives, while curbing domestic demand--in particular through reducing the budget deficit. These measures succeeded in reversing the deterioration in internal and external balances.

In September of 1987, a medium-term program for stabilization and adjustment was adopted. Main components of the program were a reduction of the fiscal deficit, a comprehensive tax and budgetary refor rgeted to decreasing the role of the budget in the process of resource allocation, and reducing the scope of taxation, a curb on the growth of credit aggregates, maintenance of positive real interest rates--especially for household deposits--, an active exchange rate policy and the adoption of new legislation instituting share-holding rights.[3] Economic performance during 1988 and 1989 was mixed; the main problem was the deterioration of the fiscal and external accounts. New measures were implemented towards the end of 1989 to address this deterioration, most notably a devaluation of the forint by 10%. The results of these measures are

[3] In the sense of Western capitalist economies

still to be assessed.

III. Financial Sector Reform in Hungary

Though the process of reform designed to increase the role of market forces in the Hungarian economy began in 1968, it was dormant during the 1970s and it was only by the mid-1980s that financial sector reform was officially acknowledged as an essential component of that process. Following the decentralization of enterprise management in 1985, bankruptcy legislation was enacted in 1986, and, in 1987 the banking system was decentralized. Progressive liberalization of pricing, wages, and foreign trade policies has been taking place since. Additionally, the tax system has been significantly simplified and its transparency improved with the introduction of the personal income tax, the value added tax, and the enterprise profit tax.

A. The Pre-Reform Financial Sector

Nationalization occurred in 1947[4]. The financial system used thereafter, up to 1968, was organized to meet the requirements of a conventional command economy characterized by centralized decision making process, with plans formulated in physical terms, and by enterprises having no available choices regarding technology or markets and being mostly administratively directed. In such a system, resource mobilization was done primarily by the state, through fiscal mechanisms, by money creation, and by domestic and foreign borrowing. Credit and money had no active role and banks had no say in allocations. The enterprise received only the credit necessary for it to comply with production plans. Assessing the credit-worthiness of borrowing enterprises was not important, since political guidelines were that the lack of resources could not

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[4] Note than only Hungarian-owned shares were nationalized.

hinder planned economic activity[5], and firms could not go bankrupt. This was made worse by the fact that for a long period investment 'loans' were non-reimbursable and bore no interest. In this context, risk assumption was not an issue, and consequently prudential regulation and supervision were unnecessary.

Financial intermediaries were limited to establishing whether the activity to be financed was planned or not, whether it had physical collateral, and whether the company's own funds were not sufficient. Another function was the financial control of plan fulfillment. Control meant verifying that the company remained within the tight limits of its working capital, wage-bill, labor-force and inventories. The characteristics of the system led also to (i) absolute sectoral specialization of bank departments, since banks' inspectors had to supervise the implementation of company plans formulated in kind and (ii) specialization by type of 'lending' since working capital financing and deposit collection were separated from investment financing.

As in other centrally planned economies, from an institutional viewpoint, the pre-reform financial sector in Hungary functioned like a 'mono-bank', where the National Bank of Hungary was both the monetary authority and the commercial bank for the enterprise sector. The money supply was determined fairly directly by means of currency issue and the control of credit to government and the banking departments. Credit control was exercised directly, and therefore the National Bank did not engage in activities such as discounting or open market operations. Since bank liabilities were not subject to reserve requirements, the limit to banks' capacity for credit extension was determined by macroeconomic

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[5] Tamas Bacskai, 'The Reorganization of the Banking System', <u>The New Hungarian Quarterly</u>. Autumn 1987. In fact, with prices, output, and input determined by the central planners, profitability indicators do not mean much and are not used as criteria for resource allocation.

decisions made at the central level and incorporated in financial plans. Credit policy served as an important complement of budgetary policy in the task of achieving a macroeconomic balance between supply and demand.

The National Savings Bank (NSB), in turn, and the associated system of savings cooperatives could only and exclusively deal with individuals (including small economic associates) at rates of interests which became highly subsidized.[6] In this system, the potential contribution of the private sector, that is, of household savings, to productive uses was limited owing to the institutional separation between the household and enterprise banking system. Enterprises became able to borrow directly from households through bond issues only in the early 1980s, but then only to a small degree, as these issues were effectively rationed by the availability of a state guarantee. All this had a clear negative impact on the efficiency of the process of allocation of resources across the economy. Up to that time there were no securities markets or equity instruments.[7,8]

B. Key Developments in the Process of Financial Sector Reform

It is now widely accepted in Hungary to achieve the objectives of the overall economic reform change in the institutions, policies, and instruments

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[6] The system of housing finance, based on below-market interest rates on credit and subsidized rents in State-owned flats, created a situation of chronic excess demand for housing. The allocation of available financial resources to housing by this system was also recognized to be inequitable, as the State support was not targeted accurately on the basis of financial need.

[7] During the 1970s, the State Development Bank was formed with the task of financing large, centrally managed investment projects influencing the basic structure of the national economy, and the Central-European International Bank--an off-shore bank with foreign participation was established. In the early 1980s, some 5 specialized financial institutions were set up, dealing with small ventures, leasing, etc.

[8] With social ownership of the means of production, equity finance is the exclusive privilege of the state.

that affect the intermediation of financial flows and change in the framework of incentives that enterprises and households face in financial decision making. will have to occur. In this section we present the key developments that characterized the actual process of financial reform in Hungary

In early 1987, a two-tier banking system was established. As of January of that year, the monopoly of the National Bank of Hungary (NBH) existing since the late 1940s was abolished. The credit functions of NBH were separated from its central banking operations, and three new full-service commercial banks were established.[9] This separation was crucial to permit an unambiguous distinction between macroeconomic control and management to be carried on by the monetary authority--and business activity--to be carried on by the commercial banks. Moreover it was a pre-requisite to enable the monetary authority to assume its

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[9] Note that this process began in 1986 as the autonomy of the two credit sections of NBH was progressively increased. The credit sections maintained separate balance sheets from April 1986, their costs were computed separately from those of the "central banking" part of NBH, and working groups were set up to divide the loan portfolio and other assets and liabilities of NBH. On January 1, 1987, the credit sections were converted formally into two commercial banks (the Commercial and Credit Bank (CCB), and the Hungarian Credit Bank (HCB)). A third bank, the Budapest Bank (BB), was formed at the same time from a combination of the commercial banking wing of the State Development Bank, the Credit Bank of Budapest (a subsidiary of NBH), and the Pest County directorate of NBH. Apart from these three banks, the Foreign Trade Bank (a 100% Government-owned institution) continued to exist largely as before, without branches, and a fifth commercial bank, the General Banking and Trust Company was given authorization to become a full service commercial bank. The SDB was reconstituted as the State Development Institute, responsible for the channeling of budget funds for investment and refinancing for priority projects to the enterprise sector.

The three new banks were allocated loan accounts from the NBH portfolio. The division of the portfolio was intended to achieve a rough balance at least between the first two banks. The banks were set up as joint stock companies, with about 80% of their capital owned by the State and the remainder by enterprises. Today the State's share has decreased to about 50%.

primary responsibilities, and to force the banks to become profit-oriented units, subject to business venture.[10]

Commercial banks became free to determine the interest rates on deposits by and loans to enterprises (although given the stage of limited competition these rates closely followed the structure of interest rate on transactions between the commercial banks and NBH). A State Bank Supervisory Agency was established within the Finance Ministry. As of January 1989, an explicit process of integration of the enterprise and the household banking sectors was begun. [11]Both the commercial banks and savings institutions are now free to engage in financial transactions with both households and enterprises.[12] Clients are allowed to choose among banks. Rates for housing loans approach market rates; although significant subsidies still exist, these come directly from the central budget.

In the area of monetary and credit policies the NBH began to resort to indirect ways to conduct monetary management and to contribute to central government financing needs. It has been using changes in the interest rate level on refinancing credits to affect credit expansion. It introduced treasury bills to finance an increasing part of the budget deficit through tapping the money

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[10] L. Bokros, 'The Conditions of the Development of Businesslike Behavior in a Two-Tier Banking System. An 'Ex Ante' Evaluation of the Hungarian Banking Reform', <u>Acta Oeconomica</u>, Volume 38 (1-2), 1987.

[11] In 1988 commercial banks were permitted to sell bonds to households, which constituted a first step toward the integration of enterprise and household banking.

[12] Ceilings apply to interest rates on household deposits, however, are subject to a 100 percent reserve requirement during two months. Also, as of mid 1989 the following rate ceilings applied in the household market: (i) 19.5 percent for housing loans; (ii) 25 percent for non-housing loans; (iii) 18 percent for deposits with a maturity of less than 1 year, and 20 percent for deposits with a maturity of between 1 and 3 years.

market, with the bills being sold through an auctioning procedure[13], and introduced open market operations.

The state stopped guaranteeing bonds sold to the public.[14] This (i) allowed for the integration of the bond markets for enterprises, and households, which up to January 1988 had developed separately on the basis of the required state guarantee for the households, (ii) eliminated the implicit system for rationing the supply of household bonds, which had created excess demand on this market, and (iii) permitted bond financing to develop according to the credit-worthiness of the issuing company.

Other recent developments include: (i) a new Law of Association that permits individuals to form limited liability and joint stock companies and to hold negotiable shares in joint stock companies;[15] (ii) enterprises, to promote competition in the banking system, are allowed to open checking accounts in more than one bank; (iii) a new tax code, to promote long-term financial savings through private financial intermediaries, that establishes a tax credit for individuals' contributions to private pension savings accounts;[16] (iv) a new company profit tax law, to promote financial discipline and profit maximizing behavior in the enterprise sector, that introduces a unified corporate profit tax which aims to ensure a uniform profit tax framework for all enterprises, regardless of their legal structure or size; (v) a law of enterprise

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[13] As of May 1989 the yield on 90-day bills auctioned was 18.4%.

[14] Such guarantee remains only for treasury bills.

[15] In a related step, a new Law on Foreign Investment was enacted in December 1988, which established a modern legal framework for foreign participation in Hungarian enterprises.

[16] The social security system has been separated from the state budget, and the basis of its independence is being gradually established; however, there are still no private pension funds.

transformation, approved in June 1989, that enables state enterprises to convert themselves into joint stock companies; and (vi) a new Securities Market Law that is under preparation and is expected to be enacted later in 1989. The law will cover the establishment of a securities supervisory body, a stock exchange, rules for trading, information disclosure requirements, and specific aspects in the area of investors protection such as those related to insider trading.

By early 1989 the number of financial intermediaries (excluding the savings cooperatives) had increased from 8 in 1983 to 27[17]: four banks had foreign participation,[18] and three brokerage houses had begun operations. The types of financial services and products that banks could offer were almost unlimited.[19] The securities market capitalization had grown essentially from zero in the early 1980s, to approximately Ft 120 billion (equivalent to $2.3 billion), an impressive growth even though the figure is still small compared with the size of the total domestic credit granted by the financial sector, of approximately Ft 1200 billion.[20] An International Training Center for Bankers, formed as a joint venture between the Hungarian banks and the Centre Internationale de

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[17] One development financial institution, 18 commercial banks, 4 specialized financial intermediaries, and 4 insurance companies.

[18] Citibank and Unicbank deal in both foreign and local currencies. The Central-European International Bank, Ltd. (CEIB) is an off-shore bank, and the Central European Creditbank is its subsidiary that has been set up to deal in domestic currency.

[19] Significant restrictions were found only in the area of foreign exchange transactions carried by domestic banks, which currently can operate only in that market <u>with</u> the central bank and exclusively on behalf of their clients. Note further that banks are still not allowed to borrow directly from abroad.

[20] Data on the ratio of long-term debt securities and equities to total assets of deposit banks for selected countries are as follows: the Federal Republic of Germany 0.75, Japan 0.70, the United States 1.40, Chile 0.60, Korea 0.20, Thailand 0.30, Hungary 0.14.

Formation de la Profession Bancaire de France, started operation at the beginning of 1989.

IV. An Assessment of the Financial Reforms

Assessing the reform process taking place in the Hungarian financial sector would require analyzing the success of the reforms already introduced in achieving their intended objectives ... considering the necessary adjustments needed for the continuation of such reforms.

It is too soon to evaluate quantitatively how much the financial reforms have contributed to increasing savings, in general, and financial savings, in particular, and to channeling them more efficiently. Clearly, changes in financial behavior cannot be expected to occur overnight. In what concerns the availability of instruments to channel surplus funds toward the financial markets, new securities have been progressively introduced. In early 1990 there were already about 350 different bond issues, treasury bills of different short-term maturities[21], CDs, and even some 80 different shares.[22] In the last two years, household financial assets, however, have not increased substantially in absolute terms and have decreased as a percentage of GDP (see Table 1 and Chart 1). One reason for this is that, in 1987, interest rates on household deposits still monopolized by NSB and the associated cooperatives were increasingly negative in real terms (Table 2), which had a depressing effect on household savings even when there was a partial shift toward the bond market (mainly

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[21] Three, six, and twelve months.

[22] Of these, about 11 are banks, which were established as joint stock companies upon the reorganization of the banking system in 1987, another 10 are new companies created upon the breakup of one state-owned conglomerate, a handful are companies that have retained their original pre-war structure, and the remaining are new companies established to take advantage of the new Law of Association.

enterprise bonds sold by banks).[23] That the rapid deterioration of yields in real terms seems to be indeed associated with the fall in household financial holdings can be seen from Chart 2 (for total financial assets) and Chart 3 (total financial assets excluding currency).

As far as obtaining an improvement in the efficiency of the allocation of resources, however, there is still not clear evidence of any major increase in competition among banks or of a large realignment in portfolio composition. Credit continues to be largely allocated to the enterprises that accounted for the largest share of the pre-reform portfolio. The issues in this area are many and intertwined. To a large extent, stagnant if not worsening portfolio quality and composition are a result of the lack of incentives for the financial intermediaries to recognize losses hidden in the loan portfolio--a problem frequently found in Western economies. Staff remuneration schemes tied to book profits, and lack of satisfactory accounting and auditing standards clearly worsen the problem. Slow progress in dealing with problem loans is also undoubtedly a consequence of the significantly close links among borrowers, bank boards, and shareholders. The adverse consequences of such a situation cannot be overemphasized. With stagnating portfolios, and under a restrictive monetary policy needed to pursue internal balance, any increase in credit is automatically allocated to non-performing borrowers--which, directly on indirectly, control the lending institutions. The burden of tight monetary policy on the enterprise sector is born mainly by the efficient, viable enterprises which are crowded out of the credit markets. Supply response is delayed if not paralyzed. In parallel, increases in net domestic credit to non-performing enterprises become

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[23] Clearly, the decline in real income may also have adversely affected household savings.

purely inflationary, as credit fuels growth in monetary liabilities not matched by growth in real assets.

Improvement in credit allocation requires, additionally, new management policies and procedures that effectively substitute the old ways of the centralized system. Essential within such program is the adoption of adequate credit evaluation and loan follow-up processes that allow for the ex ante identification of the risks implicit in each operation, and the ongoing monitoring of the borrower's financial condition and repayment capacity.

In the area of macro-financial management it is important to establish whether as a consequence of the ongoing reforms the central monetary authority has enhanced its control over the outstanding stock of money in the economy and has strengthened its ability to affect short-term variations in that stock. Among others this will depend on the availability of a diversified enough menu of instruments available for monetary management and for affecting the economic behavior of the public.

Effective monetary control can only be achieved to the extent that economic agents outside the government, particularly banks and enterprises, operate under binding credit constraints both in terms of quantity and prices (interest rates). It is apparent, however that despite advances in this respect, financial discipline has yet to be fully imposed. For example, though the Bankruptcy Law was enacted in 1986, so far it has basically been applied to small firms and not to large state enterprises. This again is in part a result of the significance of insiders' lending in the Hungarian banking system, where frequently banks' shareholders turn out to be the non-creditworthy debtors. Also, with many enterprises bordering bankruptcy due to liquidity problems and permanent losses, leading economic institutions have undoubtedly feared the social impact of regular bankruptcy processes.[24,25]

It is still unclear if both banks and nonfinancial enterprises function under the principle that loans must be serviced and, particularly, that they should be repaid at maturity because no automatic rollovers will take place. But without the hardening of the budget/credit constraint of the major operators in the financial market it will be difficult, if not impossible, to attain meaningful monetary control.

Moreover, a soft credit constraint is usually coupled with a weak accountability of managers for their financial decisions. This clearly contributes to the problem identified above of lack of incentives to improve the composition of the portfolio of the financial institutions. Here again it is evident that part of the difficulties and problems are unavoidable at the beginning of such a drastic reform process. In the short run it is not only difficult to change attitudes, but also there are major practical limitations in terms of the availability of physical and human resources needed to support an up-to-date efficient financial system.

Of utmost importance in the process of hardening the financial budget constraint is the true autonomy of the managers of financial institutions vis-a-vis the centers of political power, and vis-a-vis their borrowers, which should also acquire genuine autonomy in their decision making process. Clearly, as long as a few borrowers continue to account for large shares of the capital of the

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[24] Marton Tardos, The Hungarian Banking Reform, Financial Research Ltd. Budapest.

[25] The authorities have often complained about the fact that the banks have not initiated bankruptcy procedures. However, the same criticism could be applied to the State, which, as an owner, is also authorized by the law to initiate such procedures.

institutions, genuine autonomy of bank managers vis-a-vis their clients is hardly attainable. Also, the financial institutions themselves must be enforced financial discipline, which (i) has clear implications for how the rediscount mechanism should work and (ii) requires that the supervisory authority be given all the power to impose corrective measures whenever necessary. If business decisions are made exclusively on the basis of the Government's announced expectations about the institutions' behavior, or on the basis of the expectations the Government is perceived to have, many of the benefits of a decentralized financial system will never surface. The problem of lack of true autonomy may come up both in the large cities, specially vis-a-vis large government enterprises, or at the regional level, where branch managers may experience a similar implicit lack of control owing to the very influential local political presence.[26]

With respect to the menu of instruments available for monetary control, the main concern has to do with the existence of short-term financial assets that can be purchased and sold easily and without large transaction costs. As mentioned above, the authorities have begun to issue short-term treasury bills, which were very well received by the public and commercial banks. However, the total amount is still minimal (Ft. 5 billion or about 1.5% of M1, which is clearly insufficient to conduct meaningful open market operations), the secondary market is at an embryonic stage of development, and its dynamic characteristics are still to be assessed. So far, central monetary control mechanisms have been refinancing credit ceilings, upper limits on the interest rates on household

[26] Note that this has some implications for bank branch policy, at least during the initial stages of the reform. In fact, it may be recommendable that branch autonomy vis-a-vis headquarters be curtailed as a way to break away from regional political leadership.

deposits (in banks other than the NSB), and compulsory reserve requirements; credit ceilings are bank-specific (related to their size). Clearly, the heavy use of this type of instruments, which although potentially effective in the short-term, are inefficient compared with indirect controls implemented for example through open market operations, reveals the need for further progress in the area of monetary management.

In the area of monetary macroeconomic management, the effectiveness of monetary policy is largely conditioned by the presence of a stable demand for real money balances. A crude estimation (Table 3) points out that such demand is clearly responsive to economic activity (with elasticities close to unity as expected) but the negative correlation with the rate of inflation, although apparent, cannot be definitively established.

V. Concluding Remarks

Within the new economic system emerging in Hungary, following the extensive reforms of the last two decades, financial policy ceases to play a passive role merely supporting the achievement of physical production targets of a centralized plan and becomes a crucial indirect lever for managing macroeconomic policies as well as for achieving a better and more efficient allocation of resources.

In order to reach these objectives a thorough reform of the financial sector is required, much of which is indeed underway. We have attempted here to identify the main tasks and targets of the financial reform, as well as to assess its achievements, in the context of an economy which is restructuring toward a more market-oriented system, and in which economic agents have more financial resources at their disposal and are becoming increasingly more responsible for the consequences of their financial decisions.

The first steps of the Hungarian financial reform are clearly in the right direction and given the short time elapsed they have been successful. Progress has taken place not only in form but in substance. However, changes in macro-financial indicators are still of little significance, indicating that administrative and technical obstacles are still in the way and that a deepening of supporting measures is required.

Among those, four aspects deserve high priority. The ability of the monetary authority to conduct monetary policy must be enhanced. This requires, for example, the development of an interbank money market to deal both with shifting liquidity needs and with more lasting differences between deposit and loan growth at individual institutions. Interbank markets contribute to monetary control through making liquidity conditions more homogeneous across different financial institutions, and ensuring that the results of measures adopted by the monetary authority are not distorted due to an uneven distribution of excess reserves across those institutions.[27] Additionally, enhancing the ability of the monetary autho ty to conduct its policies requires the up-grading of the monitoring and forecasting capabilities; in particular, the use of indirect instruments requires the authorities to make frequent decisions in terms of their participation in the market, and make it mandatory that policy-makers are continuously and fully informed about market developments. A second aspect is the improvement of the operating and, most important, the financial condition of the existing financial intermediaries. Third, healthy competition among financial intermediaries should be encouraged. Last but not least, a

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[27] Up to the present, the interbank market in Hungary is being used mainly to fund lending operations rather than to manage reserves and cash flows. One of the impediments to the development of a very short-term and overnight market has undoubtedly been the difficulties in the process of clearing of interbank transactions. The authorities are currently addressing this issue.

satisfactory prudential regulatory framework must be established, that, in particular, does not discriminate against the development of the securities markets.

TABLE 1

HOUSEHOLD FINANCIAL INDICATORS

	1981	1982	1983	1984	1985	1986	1987	1988
				In billions of Forints				
1. Currency	76.0	80.0	88.2	98.3	110.0	122.7	144.3	152.0
2. Demand and Time Deposits	153.7	167.6	187.0	206.6	229.0	257.7	268.2	286.7
3. Saving Notes	6.4	8.2	10.1	12.8	15.1	17.8	18.4	19.5
4. Bonds	0.0	0.0	0.1	0.9	2.7	6.8	12.0	0.2
5. CDs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	6.6
6. Total Household Financial Assets	236.1	255.8	285.4	318.6	356.8	405.0	442.9	465.0
7. Total Financial Assets	378.4	406.7	426.4	479.8	520.9	572.0	474.7	464.[illegible]
GDP	780.0	847.9	896.4	978.5	1033.6	1087.8	1226.9	1400.6
				As % of GDP				
1. Currency	9.7	9.4	9.8	10.0	10.6	11.3	11.8	10.9
2. Demand and Time Deposits	19.7	19.8	20.9	21.1	22.2	23.7	21.9	20.5
(1 + 2)	29.4	29.2	30.7	31.2	32.8	35.0	33.6	31.3
3. Saving Notes	0.8	1.0	1.1	1.3	1.5	1.6	1.5	1.4
4. Bonds	0.0	0.0	0.0	0.1	0.3	0.6	1.0	0.0
5. CDs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5
(3 + 4 + 5)	0.8	1.0	1.1	1.4	1.7	2.3	2.5	1.9
6. Total Household Financial Assets	30.3	30.2	31.8	32.6	34.5	37.2	36.1	33.2

Source: National Bank of Hungary, Central Statistical Office publications, and own estimates.

TABLE 2

Nominal and Real Interest Rates

Year	Average nominal Interest on Deposits[1]	Real Interest Rate[2]
1980	4.54	-4.6
1981	4.58	0
1982	4.61	-2.3
1983	4.72	-2.6
1984	5.04	-3.3
1985	4.92	-2.1
1986	5.06	-0.2
1987	6.30	-2.3
1988	10.20	-5.5

[1]Source: World Bank Staff estimates.

[2]Deflated by the CPI.

TABLE 3

Money Demand Estimates (M1)

Quarterly Data 1981-1988

Constant	ln Y	π	π_{t-1}	$M1_{t-1}$	R^2/DW
1.664	0.903	-0.617			0.230
(0.45)	(2.91)	(1 02)			1.78
-0.175	0.719	-1.337		0.327	0.281
(0.09)	(2.16)	(1.69)		(1.39)	2.10*
1.256	0.937		-0.566		0.226
(0.33)	(2.91)		(0.92)		2.22
1.217	0.911		-0.542	0.028	0.227
(0.31)	(2.45)		(0.84)	(0.14)	2.26*

Notes:

t- values are in parentheses.

*h values for equations including the lagged dependent variable cannot be calculated since formula produces an imaginary result.

M1 = Money as in IFS, deflated by CPI. In log terms.

$M1_{t-1}$ = M1 lagged one quarter.

Y = four quarter moving average of quarterly production estimates deflated by CPI.

π = $\ln CPI_t - \ln CPI_{t-1}$.

π_{t-1} = π lagged one quarter.

CHART 1

Household Financial Indicators
(Hungary)

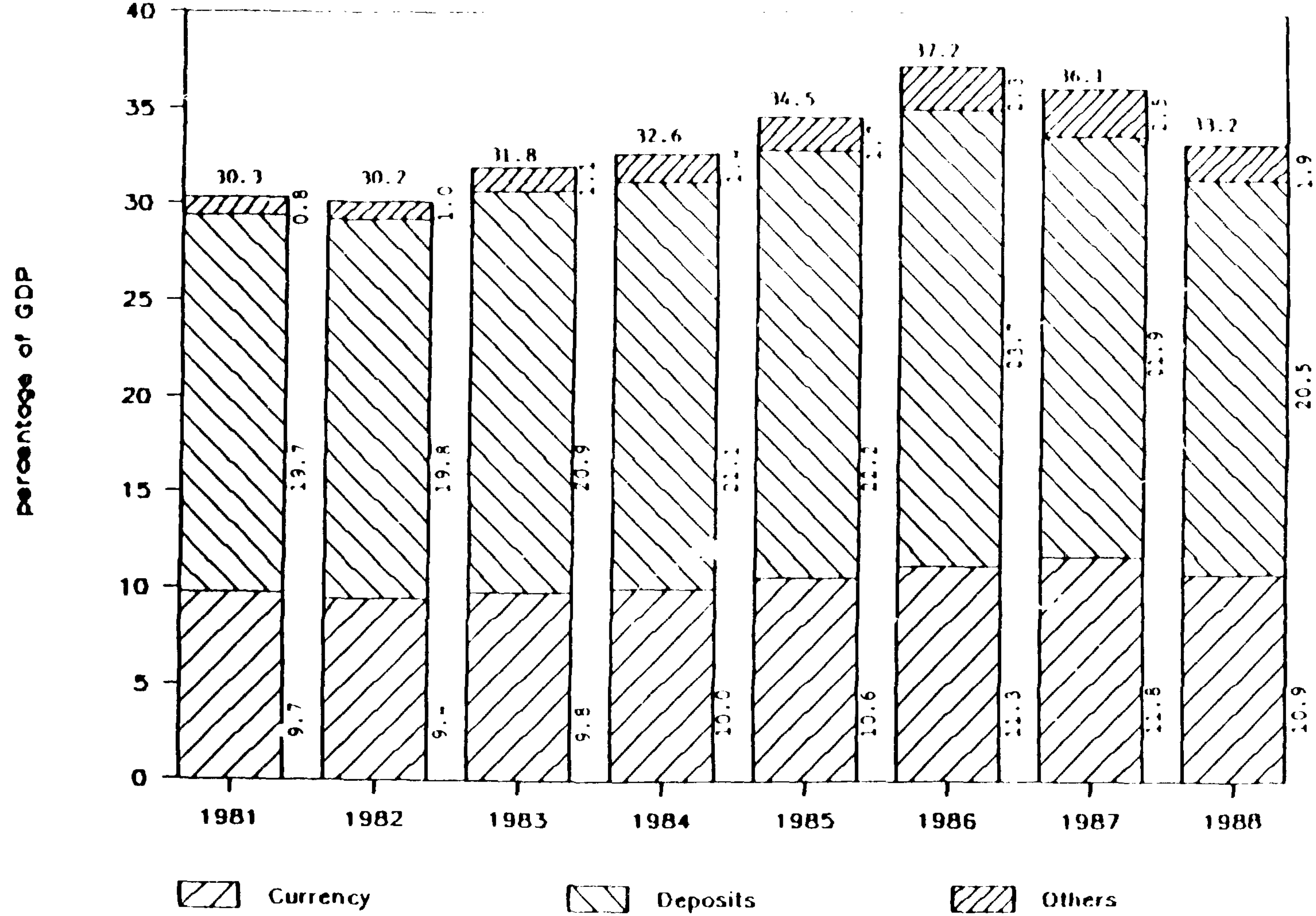


CHART 2

HUNGARY

TOTAL HOUSEHOLD FINANCIAL ASSETS AND REAL INTEREST

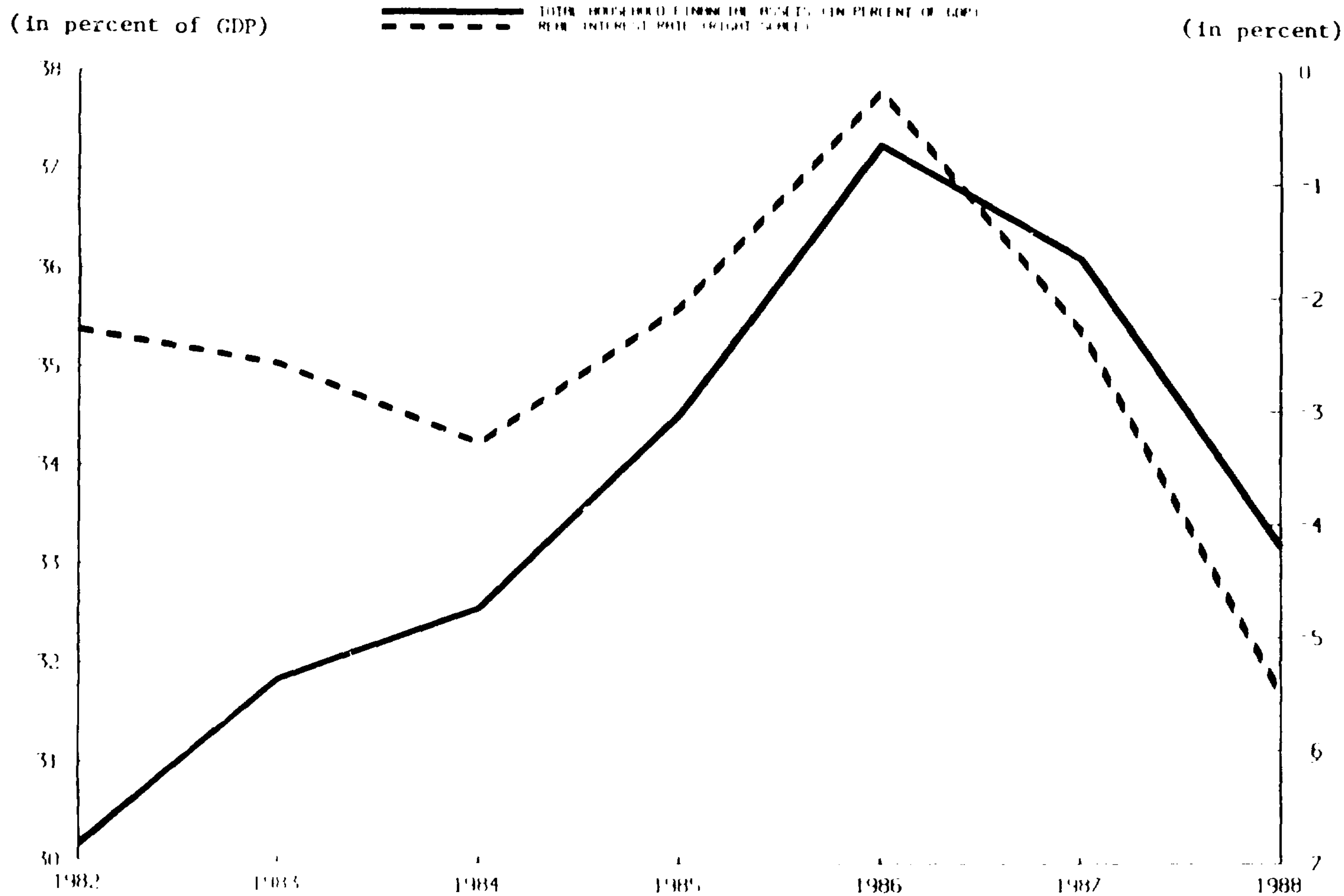
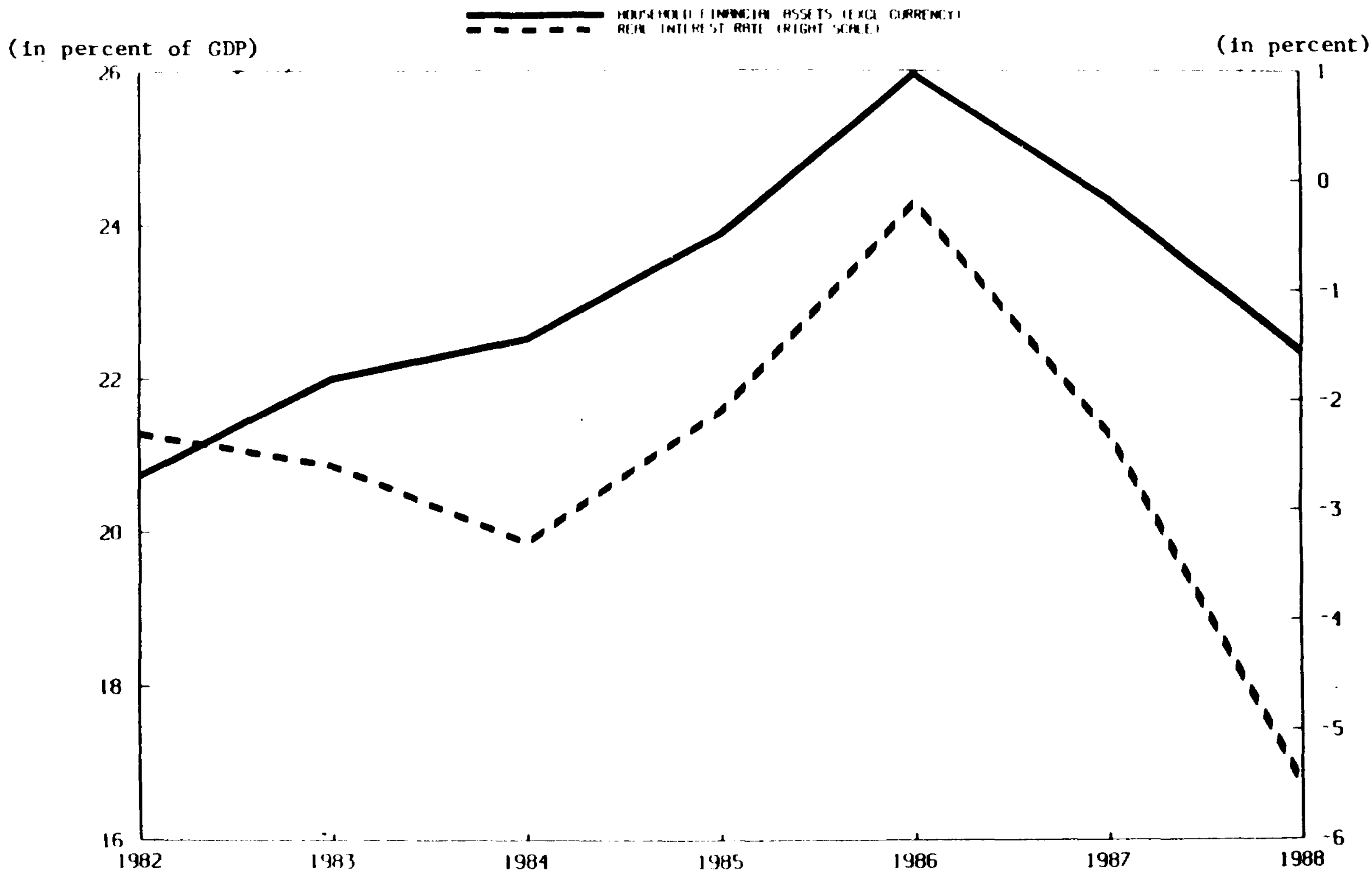


CHART 3

HUNGARY

HOUSEHOLD FINANCIAL ASSETS (EXCL. CURRENCY) AND REAL INTEREST



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